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No. 280

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

UNITED STATES OF AMERICA,
Petitioner,

v.

SKELLY OIL COMPANY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR SKELLY OIL COMPANY IN OPPOSITION

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Opinions Below

The findings of fact, conclusions and decision of the district court are reported at 255 F. Supp. 228. (R. 20-30)[1] The initial opinion and opinion after rehearing of the court of appeals are reported in 392 F.2d 128.

Jurisdiction

The initial judgment of the court of appeals was entered on April 20, 1967. The petition of the United States for a rehearing was granted on June 27, 1967 and reargument was held on July 13, 1967. The judgment upon rehearing was entered on April 3, 1968. (Pet. App. E, pp. 24-25) On July 2, 1968 the time for filing a petition for

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[1] "R" references are to the printed record in the Court of Appeals.

a writ of certiorari was extended to and including July 9, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Question Presented

Where respondent, a producer of natural gas, produced and sold the mineral during the years 1952 through 1957, and the sale price thereof entered into the computation of its depletion allowance, and in 1958, pursuant to a lawsuit, it was required to repay a portion of said sales price, does Section 1341(a)(4) of the Internal Revenue Code of 1954 require that its otherwise allowable ordinary and necessary business expense deduction be adjusted so as to reflect the previously allowed depletion allowance? The Court below, after exhaustive consideration, held that it does not.

Statute and Regulation Involved

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of develop-

ment work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341-1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

* * *

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

* * *

(26 C.F.R. 1.1341-1.)

Statement

The material facts may be summarized as follows:

Respondent, Skelly Oil Company, produces and sells natural gas in Oklahoma and was so engaged in 1952 when the Oklahoma Corporation Commission established a minimum price for sales of natural gas at the wellhead. (R. 21) This order raised the price of the gas respondent was selling under pre-existing contracts with Cities Service Company and Dorchester Corporation. (R. 22) The minimum price order was ruled invalid in *Michigan Wisconsin Pipeline Co.* v. *Corporation Commission of Oklahoma,* 355 U.S. 425 (1958), and was subsequently vacated. (R. 22)

In computing its depletion allowance for each of the years 1952 through 1957, Skelly had included in its "gross income" and in its "gross income from the property" the amounts charged under the invalidated minimum price order. (R. 23-25)

In 1958, Cities Service Company sued Skelly for $777,853.25, representing alleged overcharges for natural

gas purchased by it from Skelly between August 1, 1952 and December 22, 1957. (R. 22). Also in 1958, Dorchester Corporation, which sold gas to Northern Natural Gas Pipeline Company of America for Skelly's account, was required, due to the invalidation, to repay Natural Gas Pipeline Company for alleged overcharges and it sought reimbursement from Skelly. (R. 24)

In October and November, 1958, Skelly paid $5,536.54 to Dorchester Corporation and settled the lawsuit brought by Cities Service Company by paying Cities $500,000. (R. 22, 24) On its Federal tax return for 1958 Skelly took a business expense deduction for the $505,536.54 which it had paid to Dorchester and Cities Service. (R. 25)

Upon audit of Skelly's Federal tax return for 1958 the Internal Revenue Service reduced Skelly's otherwise allowable depletion allowance on its mineral production *for 1958* by $139,022.55, representing 27½ percent of the $505,536.54 deducted on the return. Skelly paid the resulting assessment and filed a claim and later a suit for refund. (R. 25)

The only issue presented to the trial Court was whether, in computing Skelly's liability for Federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55 representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right without restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether Skelly was required to reduce its otherwise allowable deduction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its Federal income tax returns for the years in which such

amount was taken into gross income under a claim of right without restriction as to use. (R. 12, 20)

The Trial Court held that Skelly was entitled to a deduction in 1958 of only $366,513.99 on account of the $505,536.54 payment (R. 29), but the Court of Appeals unanimously reversed holding that no legal authority supported the decision. (Pet. App. A, pp. 1-10) After granting a rehearing, the Court of Appeals reiterated its prior decision with one judge dissenting. (Pet. App. D, pp. 13-23)

Summary of Argument

The issue in this case is a very narrow one, dependent in its scope upon the peculiar circumstances of a particular taxpayer.

The Court below, after careful consideration and reconsideration, correctly held that under all judicial authority except for one obscure pre-1954 case, and under the clear mandate of Section 1341 of the Internal Revenue Code of 1954 and the intention of Congress in enacting the section, respondent, Skelly Oil Company, was entitled to take a deduction in 1958 for amounts paid out in settlement of litigation even though said litigation involved amounts received in prior years from the sale of minerals upon which a depletion allowance was afforded by law.

No double deduction is involved because two separate economic transactions are involved.

Under the annual accounting concept a "transactional" approach to the question is forbidden.

In any event, the issue is of little importance to the administration of the revenue laws because its impact depends upon the effect of the entire Section 1341 on an individual taxpayer, and the Government itself in similar circumstances has refused to apply the "tax equalization" rule it here asks this Court to create.

Respondent contends that the uniformity and symmetry of the Internal Revenue Code should not be destroyed because one taxpayer received a benefit therefrom.

Argument

1. The decision of the Court below is unanimously supported by all principles of tax accounting and by all legal authority.

The most fundamental concept of taxation, and the essence of our system of taxation, is that income and deductions must be determined on an annual basis. The doctrine was established by this Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931), and further elaborated upon and strengthened in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 418 (1932), *United States* v. *Lewis*, 340 U.S. 590 (1951), and *Healy* v. *Commissioner*, 345 U.S. 278 (1953). Most recently, this concept was flatly reaffirmed in *Commissioner* v. *Gordon*, — U.S. — (United States Supreme Court, Nos. 760, 781, Oct. 1967 Term, decided May 20, 1968), when this Court stated at page 12:

> "Absent other specific directions from Congress, code provisions must be interpreted so as to conform to the basic premise of annual tax accounting. It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."

The annual accounting approach was established in *Burnet* v. *Sanford & Brooks, Co., supra,* because of its ease of application and its production of revenue at regular intervals. In doing so the Court specifically rejected the "transactional" approach or method which would postpone the assessment of the tax, until the transaction giving rise to income or deduction is finally concluded, to the end of a lifetime or for some other indefinite period.

In *North American Oil Consolidated* v. *Burnet, supra,* it was established that if a taxpayer receives income under

claim of right he must report it as income even though it subsequently develops that its equivalent must be restored. *United States* v. *Lewis, supra,* established that in such circumstances, the taxpayer, if he was entitled to any deduction, was limited to a deduction of the amount restored only in the year of restoration. *Healy* v. *Commissioner, supra,* made it clear that the deduction must be the amount restored and is not to be limited to the *tax* paid when the restored item was originally received. It was recognized that the application of the rule could result in either a benefit or a burden to the taxpayer or to the Government.

Petitioner concedes this annual accounting principle (Pet., pp. 7, 8), states it, and then proceeds to ignore it. The Court below recognized that the application of the annual accounting rule benefited this particular taxpayer, but held that such benefit is consistent with the scheme of our taxation system. The petitioner would have this Court abort these long-established principles and grant relief in this case *despite the law.* This should not be done.

No "loss" predicated upon a single transaction is involved in this case. The gas was produced and sold over a five-year period. Such a "transactional" contention was rejected completely in *Burnet* v. *Sanford & Brooks Co., supra.* Respondent here was sued for over $700,000 and settled the litigation by paying $505,536. This *payment* is deductible under Section 162 of the Code as an ordinary and necessary business expense of the year 1958 and not as a loss. *Kornhauser* v. *United States,* 276 U.S. 145 (1928); *Welch* v. *Helvering,* 290 U.S. 111 (1933); *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). No provision of the Revenue Code or judicial or regulatory authority requires or permits the tracing of the amounts paid out in 1958 back to the years 1952 through 1957 so as to eliminate from the deductible amount the depletion allowance legally permitted when equivalent amounts were received from the production and sale of gas.

The case of *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952), is not to the contrary. That case stands for the

proposition that the *nature* of a proposed deduction, i.e., whether it is a capital or ordinary, *or even allowable at all,* may be determined by reference to the facts giving rise to the *repayment,* but it does not permit the facts of the original receipt to be reevaluated and the tax consequences thereof to be redetermined. *National Life & Accident Ins. Co.* v. *United States,* 244 F. Supp. 135, 139 (M.D. Tenn. 1965), aff'd on other issues, 385 F.2d 832 (C.A. 6th 1967). *Arrowsmith* had nothing to do with the *amount* of the deduction. The fact is that in *Arrowsmith* there could have been no deduction at all under the Code unless it was a capital loss deduction. In the instant case the *amounts* paid clearly qualified as ordinary and necessary expense deductions and have only an incidental relation to the depletion allowance in prior years. *Kornhauser* v. *United States, supra.* Petitioner has in fact stipulated, and does not now dispute that the amount is otherwise deductible unless limited by Section 1341.

The repayment in this case was because of money previously received but the prior depletion allowance was not involved in the litigation. Respondent was not sued because it took a depletion allowance to which it was not entitled. It was sued for damages on account of overcharges resulting from the minimum price statutes. But respondent produced and sold the gas in 1952 through 1957 and was entitled to the depletion allowance. The repayment arose out of the lawsuit for overcharging and was not based upon an allegation of lack of title to the mineral.

There is no provision of tax law that requires that all deductions for business expenses paid out of the *proceeds* from the production and sale of minerals, upon which a depletion allowance was once secured, must be reduced by the amount of depletion previously allowed. That, however, is the basic thrust of petitioner's contentions. The characterization of the deduction as a "loss deduction," in an attempt to avoid the impact of the annual accounting

rules, and thus subliminally superimpose on the issue the long discredited transactional approach, does not strengthen petitioner's cause.

The fact is that respondent produced and sold the mineral, and was entitled to the depletion allowance under the law. In a later year it paid back some of the money it had charged for the mineral but the entire series of transactions occurring between 1952 and 1958 cannot now be reconstituted as if they never happened. The law specifically prohibits such procedure.

The analogy of a dividend transaction between domestic corporations is not in point for the simple reason that, upon repayment, the receiving corporation would not be entitled to any deduction at all, as the repayment would not be a deductible expense but a contribution to capital. See *Walter E. Kramer* v. *Commissioner*, 27 B.T.A. 1043, 1048 (1933).

What petitioner proposes is the engrafting of a new rule of law onto the Internal Revenue Code so as to enable it to prevail in *this case only*. It is contending that the otherwise allowable *deduction* of $505,656, which the respondent without question *paid out*, must somehow be adjusted so as to equalize the *tax* for one year (1958) with the *tax* paid in 1952 through 1957 on amounts which totaled $505,656. This is impossible unless Section 1341(a)(4) of the Code somehow created a new definition of the current year's deduction, which it did not. Compare Sections 1341(a)(4) and 1341(a)(5). Presumably petitioner proposes to do this *solely* in this case because it is satisfied that the adjustment proposed would, in fact, equalize the tax. But that would not necessarily be the case for other taxpayers. Should the entire symmetry and scheme of the Code be upset in order to deal with one taxpayer? This Court said "no" in *Lewyt Corporation* v. *Commissioner*, 349 U.S. 237, 240 (1955), with the following language:

> "But the rule that general equitable considerations do *not* control the measure of deductions *or* tax benefits cuts both ways. It is applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. * * *" (Emphasis supplied)

The *ad hoc* creation of an *inverse* tax benefit, or "tax equalization," rule would not sustain petitioner's contention, primarily because *no tax benefit* is involved. Compare Section 111, Internal Revenue Code of 1954. Respondent *paid out* money, it did not *recover* it. Its mineral was not restored, it is gone forever. If, as contended, the previously allowed depletion allowance were restored to income in 1958 (thus creating income where none exists) would a depletion allowance be allowed on that *created* income? It would have to be "gross income from the property" for depletion purposes or else there would be no reason for the "credit to income." By the same token, if an operating loss was experienced in the prior years, would petitioner be so apt to apply the rule it proposes in this case?

Petitioner would have this Court create a new rule of law with widespread ramifications just to penalize one taxpayer—a rule that would be engrafted upon, or replace, the tax benefit rule, and which would require *tax equalization* dependent upon the long term economic result of a transaction or group of transactions. To do so this Court would have to add a new section to the Revenue Code and overrule a long line of legal precedents that are the foundation of our taxing system. See, e.g., *American Automobile Assn.* v. *United States*, 367 U.S. 687 (1960).

It is highly improbable that the Government would, in the long run, benefit from the creation of a new tax equalization rule because it would most likely be applicable only to respondent's situation and only for this particular tax year. Other taxpayers who restored income received under claim of right might have paid *no* tax in the years of receipt, despite the allowance for depletion, or the depletion allowance may have had little economic benefit to them depending upon the area rate, the field price of the mineral and/or their costs of production. What adjustment would then be made to "equalize the tax?"

Petitioner's strenuous effort in *A. P. Sullivan Corp.* v. *United States,* 381 F.2d 399 (Ct. Cls. 1967), to persuade the Court of Claims to overrule a "tax equalization" doctrine enunciated in *Perry* v. *United States,* 160 F. Supp. 270 (Ct. Cls. 1958), vitiates the validity of its petition to this Court in the instant case.

2. The purpose and intent of Section 1341(a)(4) of the Revenue Code supports the decision of the Court below.

The Court below did not interpret Section 1341(a)(4) as providing a "loophole" of any kind. It applied it as it is written and as it was intended to be applied by Congress. Further, it was never contended, and the Court below did not hold, that this Section created a new deduction. By the same token, it does not operate to limit a taxpayer's recovery to a *tax* no greater than the tax originally paid with respect to the restored claim of right item.

Prior to the enactment of Section 1341 as part of the 1954 Code, a taxpayer who had previously included an item in gross income under the claim of right principle of *North American Oil Consolidated* v. *Burnet, supra,* was required to take a deduction for the repayment of that item in the year of such repayment. *United States* v. *Lewis, supra,* specifically held that in the claim of right situation a taxpayer should deduct the amount which he was required

to restore *in the year of repayment* and in no other year. Congress, in enacting Section 1341, provided that under claim of right circumstances of taxpayer must *either* (1) take a deduction for the year of repayment, *or* (2) recompute his tax for the year of receipt by excluding the receipt, *whichever produces the greater benefit.* No *option* is involved! The section is *mandatory.* The clear truth is that Congress sought to and did remove the *burden* on the taxpayer resulting from the application of *United States* v. *Lewis, supra,* while preserving to taxpayers the *benefits* which were recognized as possible under that decision.

Contrary to the assertions in the petition, it was not the intent of Congress to overrule completely the rule of law enunciated in *Lewis* and *Healy.* The Committee Reports clearly explain that the purpose of Section 1341 was to ameliorate *one* of the aspects of those cases and leave the others as provided by existing law. And prior law did *not* deny the deduction allowed in the instant case—it required it. Senate Report No. 1622, 83d Cong. 2d Sess., pp. 118, 451, specifically points out that:

> "Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the *deduction* allowable in later years does not compensate the taxpayer adequately for the tax paid in the earlier year.
>
> * * *
>
> "If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by *either* the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, *whichever is greater.* Under the rule of the *Lewis* case (340 U.S.

590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment." (Emphasis supplied.)

Under the rule espoused by petitioner there would be no alternatives. The tax effect of repayment would always be commensurate with the prior *tax* paid. Thus, Section 1341(a)(4) would be vitiated.

The adjustment-of-*tax*-for-the-year-of-repayment method, which the petitioner sought to sustain in the Court below, has been rejected by Congress many times. [See, Statement of Ellsworth C. Alvord, Hearings on H.R. 7378 Before the Senate Committee on Finance, 77 Cong. 2nd Sess. 1784 (1942); American Law Institute, Federal Income Tax Statute, Sections X332, X333 (Feb. 1954 draft).] Moreover, while seeking such judicial amendment to the Revenue Code in this case, the petitioner was simultaneously urging the Court of Claims to *apply* the very principle of the instant case where that application redounded to *its benefit*, even though such result overruled a long-standing precedent. See and compare, *A. P. Sullivan Corp.* v. *United States, supra,* overruling *Perry* v. *United States, supra.* Pointing out that the taxing statutes must be literally applied as enacted, and without reference to equitable considerations, the Government persuaded the Court of Claims to overrule its previous decision, however inequitable the result to the taxpayer. In doing so petitioner based its argument on the very principles of law relied upon by the Court below in the instant case.

If petitioner's "tax equalization" theory had any foundation in law there was no need for Congress to enact Section 1341. Thus the petition for certiorari asks this Court to invalidate Section 1341 of the Internal Revenue Code of 1954, or at the very least, subsection 1341(a)(4) thereof.

The contention that the Court below "confused" the terms "item" and "deduction" by regarding them as having the same meaning is a pseudo-intellectual exercise

without foundation in fact. It did not do so. The Court below concerned itself with whether the *deduction* referred to in Section 1341(a)(4) must be limited by the *tax* paid in prior years, and concluded that under all legal authority and legislative history it was not, and was never intended to be so limited. As a matter of law, Section 1341(a)(5), which petitioner would have the Court substitute for Section 1341(a)(4), requires only that the "item" referred to be previously included in "gross income." But the *full amount* of the proceeds from the sale of gas were reported in "gross income" by respondent! The depletion allowance has no relation to "gross income" but rather to "gross income from the property"—terms of art in the field of taxation which are not synonymous. See Revenue Ruling 60-344, 1960-2 CB 186. The Treasury Department often applies the distinction to maximize the collection of revenue.

The truth is that Congress has devised an orderly, uniform method for dealing with questions such as are involved in the instant case. Petitioner has no compunctions about strictly applying the letter of the law to taxpayers when the result is to its benefit. See *A. P. Sullivan Corp.* v. *United States, supra;* see also, *Income Tax-Recovered Property Previously Deducted Included in Gross Income in Year of Recovery,* 66 Michigan Law Review 381 (No. 2, December 1967), especially footnotes 19, 24, 25.

But "(t)he basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." *Healy* v. *Commissioner, supra,* at pages 284-285.

Under the statutory scheme of the Revenue Code there are at least eleven situations in which the application of Section 1341(a)(4) will result in a benefit to taxpayers. Petitioner has not challenged these benefits except in the instant case which involves the depletion allowance, even though such benefits have been apparent for many years. There are probably as many situations where the results are detrimental to taxpayers. It is submitted, however,

that the law must be evenly applied and the entire statutory scheme and all case law cannot be abrogated in order to penalize *one taxpayer*. See discussion of administrative importance and ripeness for review, *infra*, pages 19-22. It must also be remembered that the recipients of the amounts paid by respondent must include the *total* amount paid in their gross income. Any reshuffling of the statutory scheme may thus involve not only Section 1341 but other sections of the Code as well. Such overall reformation, even if desirable, is the task of Congress, not of the Courts.

Actually, the scope of the decision below is very limited. The decision is not one of broad application or uniform impact; whether it benefits or burdens a taxpayer depends upon the specific circumstances in each case. See discussion, *infra*, at pages 19-22. For example, if a loss had been incurred by respondent in the year of receipt despite the depletion allowance, resulting in no tax benefit, would the petitioner advance this "tax equalization" theory? If the properties which produced the mineral had been abandoned in the interim, could the "transactional" argument still be made? It is submitted that the narrow issue raised by the Government in this case is not ripe for review by this Court. Too many questions have been left unanswered.

The Treasury Department is currently studying proposed tax legislation which may well make the issue in this case moot. See New York Times, July 21, 1968, pages 1, 24. Respondent submits that the broad overall tax reform urged upon the Court by this petition for certiorari should best be left to Congress.

3. No double deduction is involved in this case.

The assertion of "double deduction" in the petition for certiorari is specious at best and untrue at worst. No "double deduction" is involved. The fact is that respondent sold gas in the years 1952 through 1957. It was en-

titled to the depletion allowance under the law because it produced and sold the mineral. Its mineral deposit was, in fact, depleted—no question with regard to that is involved in the case. In a later year, 1958, pursuant to litigation, respondent was required to pay $505,536 to the purchasers of its gas upon the settlement of a suit for $700,000. The deduction of the amount paid out no more constitutes a double deduction for depletion than does the deduction of wage and salary expense, or any other expense of doing business where the *money used* to pay such expenses was originally derived from mineral production on which depletion was allowable under the law.

Depletion is allowed because of the production of the mineral which is a wasting asset and as long as the mineral is produced and sold the deduction is permitted under the law as a restoration of capital. Not all mineral producers are entitled to the same rate and even in the same industry the allowable amount varies widely depending upon net income from the property limitations, overhead expense, extraction and processing costs, and sales price of the mineral. Even aside from consideration of the annual accounting requirement there is a wide gulf between the depletion allowance and an ordinary business expense.

The case of *Ilfeld Co.* v. *Hernandez*, 292 U.S. 62 (1934), is not pertinent. There the Court refused to allow the taxpayer to deduct the *same economic loss twice*, because to do so would constitute the allowance of a double deduction, but the situation there is far removed from that of the instant case. There the taxpayer experienced only *one loss* and sought to deduct it twice. Here the taxpayer produced and sold the mineral and was legally and validly entitled to the depletion allowances in the years of sale because its *mineral was depleted*. In a later year it was required to pay $505,536 to the purchasers and it was legally and validly entitled to deduct the amount paid as a business expense. It thus suffered *two* losses. Its mineral was forever depleted and its $505,536 was paid out.

There is no provision of tax law that requires that the depletion allowance be continually adjusted retroactively depending upon subsequent events, as petitioner would have this Court believe.

4. The case of *Douglas* v. *Commissioner* does not support the proposition for which it is cited in the petition.

In *Douglas v. Commissioner*, 322 U.S. 275 (1944), this Court held valid a Treasury Regulation which required that depletion allowed on advance royalties, received before actual production, must be restored if the mineral lease was later cancelled and *no* production of mineral ever took place. Petitioner failed to mention, however, that that Regulation provided, and current Regulations still provide, that the depletion must be restored *only* if the lease expires, terminates or is abandoned before *any* production is attained. If *any* mineral is produced, however, no matter how much, no restoration of depletion is required. See, Treasury Regulations Secs. 1.612-3(a)(2), 1.612-3(b)(2); *Dolores Crabb* v. *Commissioner*, 41 B.T.A. 686 (1940); *Waggoner* v. *Commissioner*, 47 B.T.A. 699 (1942), acquiescence 1945 CB 7; Revenue Ruling 1968-78, I.R.B. 1968-7, 18. In the instant case there was no failure of production and the leases did not expire or terminate and were not abandoned. The mineral which gave rise to the depletion allowance was produced and sold and Respondent has continued to produce minerals from all of the properties involved. Respondent did not recover the *mineral* sold in prior years or any rights thereto. It is gone forever.

The *Douglas* rule thus holds that if production is never obtained and, therefore, no depletion of the mineral occurs, the depletion allowance previously deducted must be taken into income. *But* if some production is obtained no restoration is required because the original amount received constitutes the sales price of, and hence the gross income from, the production of the mineral. This is the only workable rule. Otherwise a *hypothetical* value, for depletion

purposes, not based upon "gross income from the property" would have to be established for all minerals by the Treasury Department in each producing area throughout the world. This would be directly contrary to the Revenue Code.

5. This case is of no administrative importance and is not ripe for review by this Court.

Petitioner's allegations that large amounts of revenue will be jeopardized as a result of this decision and the decisions in the natural gas rate cases under the jurisdiction of the Federal Power Commission, is without foundation.

In the first place, the Federal Power Commission has jurisdiction over sellers and transporters of gas as well as producers, and *customer* refunds may have little or no tax effect when and if some amount thereof filters back to producers—the only party entitled to a depletion allowance. Even in that event, whether or not a given producer would be affected by the application of the petitioner's new "tax equalization" theory, would depend upon its peculiar circumstances, such as overhead expense, cost of production, profit or loss, etc., in both the year of production *and* the year of repayment. See and compare Sections 1341(a)(4) and Section 1341(a)(5) of the Internal Revenue Code of 1954; see *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965). In fact, if the petitioner's theory were correct then the tax adjustment called for here would require that, after the Revenue Service made its adjustment, the Federal Power Commission would have to reopen the rate cases to adjust the rates which are formulated by reference to the economics of the industry and which includes depletion but not the tax effect thereof.

It should be noted that in the *Permian Basin Area Rate Cases*, Nos. 90, et al., Oct. 1967 Term, decided May 1, 1968, this Court pointed out (p. 71, footnote 115) that in determining the average rate for basin producers an allowance

for income taxes was *not* included, the Federal Power Commission noting that the producers will incur no Federal income tax liability at any return up to 15 percent. (The Commission determined a rate of 12 percent.) The effect of the "tax equalization" adjustment proposed by petitioner would necessitate reconsideration in rate cases of the very subject matter that the Federal Power Commission refused to consider because of its difficulty and varying impact upon individual producers.

In fact, the Internal Revenue Service itself has been reluctant to attempt the adjustment proposed by petitioner. (See Technical Advice Memorandum From Natural Resources Division to District Director, St. Louis, Mo., Appendix A, pp. 1a-3a.) Acceptance of the *petitioner's* argument would not result in certainty but could only result in uncertainty in the application of the revenue laws. That is why the Court of Appeals rejected the petitioner's contentions.

The Court below did not hold that a producer who makes a refund is entitled to deductions of $1.275 for every dollar refunded. It merely held that the tax effect of business transactions cannot be held open indefinitely so as to determine their long-range economic results and that an otherwise allowable current year business expense cannot be made to depend on the original source of the funds used to pay it.

Respondent does not quarrel with the proposition that the deduction referred to in Section 1341(a)(4) must be defined by other Code provisions and the long series of precedents supporting that definition. It merely reiterates that no Code provision or judicial precedent permits what petitioner proposes to do. The only case which even gives a scintilla of support to petitioner's contention, *O'Meara* v. *Commissioner*, 8 T.C. 634 (1948), is inconsistent on its face, was not reviewed by an appellate court, and the issue involved, being one of several, was obviously not clearly

presented to the Tax Court. There, too, the real issue was whether the taxpayer was entitled to *any deduction at all.* No ordinary and necessary business expense was involved. Without the transactional approach no deduction would have been permitted. In any event, the theory applied there is precisely the theory applied in *Perry* v. *United States, supra,* which the Court of Claims, in *A. P. Sullivan Corp.* v. *United States, supra,* lately held, at petitioner's urging, was erroneously decided.

Further, in the interim after *O'Meara* Congress enacted Section 1341 of the Code and in doing so made the clear distinction between a recomputation of prior year's *taxes* and the current year's *deduction* taken by respondent, Skelly Oil Company, in the instant case. Application of the alleged *O'Meara* rule, as defined by petitioner, would nullify that distinction.

The "paucity of litigation" on the subject is clearly not because all taxpayers acceded to petitioner's contention. More likely it is either because the Revenue Service has never before pressed such a theory (see Appendix A, pp. 1-3) or the theory is just not applicable to all taxpayers because of the necessity of determining individual facts and circumstances in order to apply it.

Because of the many legal and factual problems that must still be analyzed and determined before any validity can be ascribed to petitioner's novel theory of "tax equalization" (see, e.g., *Hugoton Production Co.* v. *United States, supra*) it is submitted that this issue is not ripe for review by this Court and no purpose would be served by further review of this case.

Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Appendix A

Jan 12, 1968

District Director
St. Louis District Office

Chief, Engineering and Valuation Branch
National Office T:I:E:N:2

[Taxpayer's name and address omitted]

AU:F:227

Years: 1959, 1962-1965

This is in reply to a memorandum dated November 9, 1967, requesting technical advice as to the proper Federal income tax treatment of refunds on the sale of natural gas ordered by the Federal Power Commission (F.P.C.) and the allocation thereof to transmission, overhead and other related charges.

The pertinent facts as presented in your memorandum, a memorandum to Mr. Richard Moore, Technical Coordinator, St. Louis, dated November 6, 1967, and a letter from the taxpayer dated November 3, 1967, are understood to be as follows:

[Taxpayer's name and address omitted.]

[Taxpayer] is principally engaged in the production, long distance transmission and sale of natural gas. Such gas is transported largely in interstate commerce, and is sold along its route to some 100 local natural gas distribution companies for the purpose of resale, and also to various industries for their own use. [Taxpayer's] natural gas transmission system consists of four parallel lines and extends a distance of approximately 1,200 miles in and from the Hugoton Embayment in the states of Texas, Oklahoma, and Kansas, through the states of Missouri, Illinois, Indiana, and Ohio, into the state of Michigan. [Taxpayer] produces approximately 15 to 20 per cent of the natural gas transported and sold through its system.

Under the Natural Gas Act, (15 U.S.C. 717 *et seq*), the F.P.C. has regulatory jurisdiction over [taxpayer] as an interstate natural gas pipeline company. In general, the F.P.C. regulates the prices [taxpayer] can pay for purchased gas and the prices at which it can sell gas to customers for resale. The major part of [taxpayer's] sales are to customers for resale and are subject to F.P.C. regulatory jurisdiction. The F.P.C. also promulgates accounting rules, performs compliance audits, and generally oversees the accounting and reporting practices of the natural gas companies under its jurisdiction.

Of the gas that [taxpayer] produces, the portion that is sold at the wellhead does not go into the [taxpayer] system and is not the subject of this technical advice request. The remaining portion of the gas that [taxpayer] produces is not sold on the lease but enters the [taxpayer] transmission pipeline system, along with purchased gas, and is transported to the various markets. This latter described gas is the subject of this technical advice.

The taxpayer's depletion computation on this latter gas was based on some unstated figure which, upon audit, was "adjusted by the Internal Revenue Service to reflect depletion upon the royalty price used by [taxpayer] in making payment to its royalty owners." See November 6, 1967 letter referred to above.

It is understood that the F.P.C. in ordering the refunds, did not allocate the amount to be refunded to the cost of produced gas, or to transportation costs, or to overhead costs, etc.

The questions on which you have requested technical advice may be stated as follows:

1. "Under the facts in this case the refunds as ordered by the F.P.C. are not broken down into any parts, i.e., no portion of the sales price is allocated to the cost of produced gas, transportation costs,

overhead costs, etc. Should these total sums refunded be allocated to any of the above mentioned items?"

2. "If the value of any of the above refunds *should* ultimately be allocated to gas sales, at the wellhead, should this amount be reduced by the depletion previously taken?" [Emphasis in original text.]

Based upon the foregoing, the price of the gas at the wellhead for depletion purposes, was determined by the District Director, without regard to any sale at the wellhead (which was absent in this case) or without regard to any sale at the end of the transmission line. Furthermore, the refund directed to be made by [taxpayer], because of overcharges to its customers, was determined without regard to any wellhead price of the gas. Therefore, no portion of the sales price refund should be allocated to the cost of producing gas, transportation costs, overhead costs, etc.

In as much as it has been determined that, *under the facts of this case,* that no portion of the gas sales refund should be allocated as set out above, the total of such refund should *not* be reduced by depletion previously taken. However, in those instances wherein refunds are allocated to gas sales at the wellhead, then the amount of refund must be reduced by the depletion previously taken. [Emphasis supplied by Respondent.]

— — End — —